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A Higher Standard

Here are steps that financial advisors should be taking when acting as a fiduciary.

By David Lawrence

With increased attention on the role of fiduciaries in a financial practice, it seems reasonable to reflect on what a normal day might look like for such a person. But before beginning this discussion, it might be prudent to first identify who this person is.

A fiduciary, by definition, is anyone who handles someone else's money. When you have the legal and/or moral responsibility for managing someone else's money, it is highly likely that you will be considered a "fiduciary." Additionally, when the client is dependent on the financial advisor's advice (whether or not such client has given discretionary authority to that advisor), the advisor is likely to be deemed a fiduciary.

Such a definition would include the more than five million men and women who serve as members of investment committees for retirement plans, foundations and endowments; trustees of private trusts; and, of course, investment (financial) advisors. Those advisors who provide comprehensive and continuing investment advice, no matter what the circumstances, are acting as fiduciaries.

The Certified Financial Planner Board of Standards Inc. (CFP Board) adopted a revised version of its standards of professional conduct last year that becomes effective as of July 1. These standards, though they apply to more than 54,500 financial planners in the U.S. who are authorized by the CFP Board to use the CFP certification marks, have broader implications for all practitioners, including non-CFPs. Under the revised standards, "fiduciary" is defined as one who acts in utmost good faith, in a manner he or she reasonably believes to be in the best interest of the client.

This definition seems rather broad. However, the revised standards set forth greater detail on disclosure and suitability requirements related to the scope of the engagement with a client, detail that reinforces the role of the fiduciary in that engagement. As the word "fiduciary" does not appear in the current standards, the move to establish a definition and to incorporate language supportive of the role of the fiduciary is significant. The move by the courts to eliminate the so-called "broker-dealer rule," the exception to the Investment Advisers Act of 1940 exempting those broker-dealers from the fiduciary provisions of the act, is further evidence of a shift in support of fiduciary standards.

The Financial Planning Association (FPA), which initiated the lawsuit resulting in the vacating of this rule, has since embarked on a project to fully define standards of conduct that further embrace the role of the fiduciary. (FPA Fiduciary Task Force—Final Report, June 1, 2007.) In the 133-page report, the task force cites reference to a Supreme Court case, SEC v. Capital Gains Research Bureau, Inc., in which the court found that a fiduciary duty is imposed upon advisors by Section 206 of the Investment Advisers Act.

The court further referred to an SEC report commissioned by Congress which said, in part, "An investment adviser should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect." The conclusions of the FPA fiduciary task force included a key aspect of the role of the fiduciary concerning his or her responsibility to fully disclose any and all material conflicts of interest to clients. Again, citing the Supreme Court decision, it quoted his responsibility "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."

Therefore, it is incumbent on all financial advisors to acknowledge their potential role as a fiduciary and act accordingly where and when applicable. So, that leads to a question of just what a fiduciary does during a typical day.
Activities characterizing the fiduciary's role could fall into two distinct areas. The first of these areas might be described as "client facing." When communicating with clients and/or prospects, certain aspects of such communication should be highlighted. In any discussion, the role of the fiduciary must be disclosed. This can be done in many ways, not the least of which is verbally and in writing. Verbally, the discussion should involve an explanation of the additional responsibilities the fiduciary has (in effect, that he is being held to a higher standard).

The roles and responsibilities should be detailed in any literature handed to the client that concerns the engagement of services. This would include brochures, engagement letters, etc. If the advisor is a registered investment advisor, the ADV form and other disclosures should contain information on this role.

Conflicts of interest should be made a part of any such disclosures. These communications should also contain the advisor's code of ethics or a reference to them with an offer to provide written codes upon request. Suitability information is another key disclosure, as

are trade execution procedures (best efforts, etc.).

Another area of disclosure related to fiduciary duties is the advisor's obligation to take steps to protect client interests in the event of a business interruption. Specifically, advisors need to have a disaster plan in place that is written down and that spells out, for instance, that the advisor would be unable to provide services after a natural disaster, an injury, illness, his death or the death of key personnel in his firm. These are just a few of the many "client-facing" issues to be explored by the fiduciary advisor.

The second area might be called "firm facing." In this area, the activities of the advisor as fiduciary are highlighted. There are many examples of this. One example is in the evaluation of appropriate investments for the client. In traditional terms, advisors typically look at investment goals, performance history, asset allocation mix, fees and other indicators (such as the Sharpe index, relative p/e ratios, etc.). The fiduciary uses the acronym "TREAT," which represents the order in which the aspects of an investment are studied within an asset allocation model. "T" stands for time horizon, the first consideration for the fiduciary. "R" stands for risk; "E" stands for expected return; "A" stands for asset allocation; and the last "T" stands for tax treatment.

Noticeably absent from the acronym is fees. Though fees are important, they are not considered a priority in the investment selection and asset allocation so long as whatever they are, they are prudent and appropriate for the investment vehicle and, most important, fully disclosed to the client. Fees should always be discussed with the client, though not necessarily in the context of investment needs. Instead, fees should be discussed, in detail, in the larger context of benefit/costs to the client, not necessarily as a reason for choosing an investment. Further details on the duties of a fiduciary can be found at the Center for Fiduciary Studies' Web site (http://www.fi360.com).

Rather than seeing the responsibilities of the fiduciary as just another burden, another layer of work, you should see being a fiduciary as a positive step. Not only should you be placed in higher regard by your clients and prospects who recognize and respect your fiduciary status, but it is also likely to provide a marketing edge by offering you differentiation from those practitioners who fail to live up to such standards.

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